I. Summary of Statement of William J. Rennicke, Vice President, Mercer Management Consulting, Inc.

This statement has been prepared by William J. Rennicke, a Vice President with Mercer Management Consulting, Inc. (Mercer). I have 30 years of experience consulting to the transportation industry on a wide range of regulatory, economic, litigation, and asset management issues. I specialize in transportation strategic planning, management, marketing, economics, and operations, and have particular expertise in restructuring, organizational redesign, and transactions to improve financial and operating performance of transport operators around the world. I have previously provided expert testimony on the state of the North American rail industry on several occasions before the U.S. and Canadian legislatures. I have also directed the analysis of the competitive effects of transactions before the FTC and DOJ. My individual qualifications and experience in the railroad industry are set forth in Section III. Selected qualifications and experience of Mercer are set forth in Annex B.

My purpose in preparing this statement is to provide the Committee with Mercer's perspective on the state of the railroad industry, including its current financial conditions and transformation since enactment of the Staggers Rail Act of 1980, infrastructure capacity and its impact on rail service, and long-term capital funding needs. My testimony is based on experience working with many of the largest North American railroads as well as their suppliers and customers.

I would like to make four points before the Committee today. Several of these points are updates of testimony Mercer provided the Senate and the House in 1999. In making these points, I will refer to the supporting visual materials in Section II of the document before you.

1. **Deregulation has created an efficient and competitive rail industry and has benefited shippers, consumers, and the economy as a whole.**
   - Since the implementation of the Staggers Act in 1980, U.S. railways have become more competitive, innovative, and efficient.
   - Operating ratios for the "Big Four" Class I railroads remain positive; volume has been growing strongly; and rail productivity has improved substantially in the two decades following deregulation.
   - However, average revenues per ton-mile for major commodities in which railroads have a high market share were essentially flat or declining in the 1990s.
   - Most of the cost savings from deregulation have been shared with customers, suppliers, and other transport companies in the form of rate reductions.
   - By increasing the efficiency and reliability of railroads, deregulation has driven down the cost to the economy of moving and managing goods.
2. **Despite significant productivity and service improvements made over the past two decades, the industry faces many challenges to continued success.**
   - Rate declines coupled with unit cost inflation have continued to expand a large "rate-cost" gap for the railroads. Productivity improvements have been key to continued rail viability.

- Rates of productivity improvement now appear to be slowing. Railroads are running out of traditional sources of productivity improvement.
- While facing rate pressure on major bulk commodities, railroads are also being challenged by customers to improve on-time performance for merchandise traffic. Continued service improvements will require higher levels of capital investment.
- For example, most of the Class I railroads are investing in assets and facilities to meet the growing demand for intermodal service, particularly stacktrain (double-stacked rail) service.
- Total Class I rail capital expenditures have risen from $4.5 billion in 1990 to $6.6 billion in 1999 – an increase of 49 percent in real (inflation-adjusted) terms. Even larger capital expenditures will be required, however, for capacity expansion and new efficiencies that will enable railroads to cope with the continuing fall in revenue per ton-mile.
- The current economic environment is increasing investor scrutiny of railroad investment. Wall Street suggests that railroads may start looking to the government to assist with infrastructure funding as they get more pressure from shareholders to increase free cash flow.
- Traditional productivity improvement is not rising fast enough to maintain railroad values in financial markets.

3. **A stable regulatory environment is required to ensure the health of the industry and the continued flow of private capital.**

   - The regulatory environment is examining issues surrounding merger policy and acess regulation which could have both negative and postive impacts on railroads.
   - Wall Street and rail executives emphasize the paramount importance of predictable and growing cash flows. The introduction of regulatory uncertainty can disrupt the stability and growth of rail industry cash flows and correlate directly to stock prices.
   - Experience in other countries has shown that so-called “competitive access” regimes can often leave the rail infrastructure owner inequitably at risk for the layers of cost involved in providing competitor access to its network, with consequent impacts on the owner’s ability to recover value from its assets.
   - The U.S. and Canada are the only countries in which the private sector is primarily responsible for providing infrastructure and equipment. Elsewhere, experiments in regulatory change that move to greater levels of competition have disrupted normal investment cycles and led to increased government intervention and subsidy.
   - In the United Kingdom, the government just announced that it would provide an additional 3.4 billion pounds in funding for the rail freight network and would cut access charges in half over the next decade to try to reverse a loss of freight from rail to road (rail’s share of the freight transport market has dropped to a new low of 6-7 percent).

- The tragic mistakes made in utility deregulation in California have led to increased financial involvement by the public and investor uncertainty in the sector.
- Uncertainty surrounding the possibility of open access and the impact of new STB merger rules will make it even more difficult for Wall Street to reward additional investment through higher stock prices.

4. Commercial alliances between railroads and third parties will be needed to fuel additional substantive productivity gains for the railroads.

- With historical drivers of productivity improvement becoming tapped out, railroads are likely to turn to extended business partnerships and strategic alliances (short of merger) in order to create new value.
- By "unbundling" the rail value chain, railroads can identify partner companies that may be more efficient providers of distinct services or more appropriate owners of distinct assets.
- Alliances can be formed between a railroad and another railroad; directly between a railroad and a third party (such as a supplier); or between a railroad and an intermediary (such as a financial investor).
- Because direct railroad-to-railroad collaboration can be difficult to execute, indirect collaboration through intermediaries (either traditional or new Internet-based intermediaries) is often easier.
- The largest potential to create value for railroads will likely come from alliances with third parties, including equipment, infrastructure, and facility providers; financial institutions; and technology and e-commerce providers. Other asset-intensive industries (e.g., airlines) have already demonstrated the potential for alliances between buyers and suppliers.
- Railroads are now looking to suppliers for innovative ways to ease capital investment levels and increase productivity. To capture these opportunities, suppliers will have to take larger stakes in the rail value chain and develop closer working relationships with railroads.
- Value-creating business alliances will become more critical for railroads and suppliers if the economic slowdown continues.
- Railroads will likely follow the example of successful multi-party alliances in other industries such as aviation, ocean shipping, and technology where traditional fucntions of the vertically integrated companies are now shared with vendors.
- After their successful turnaround in the 1980s, railroads are once again at a crossroads between a "railway renaissance" and renewed decline.